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TREASURY FOR FTAT, OCC/SIEGEL, AND OASIA/ICB/ATUKORALA
TREASURY PASS FEDERAL RESERVE, FINCEN, AND SEC/JACOBS

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TAGS: EFIN AU XH
SUBJECT: Banking in Central/Eastern Europe: Austrians
to Stay the Course, But Say Risks Abound

REF: VIENNA 1751 and previous

Sensitive but Unclassified - Entire Cable.

¶1. SUMMARY. The financial crisis has triggered
concerns about Austrian banks' huge exposure -- over
EUR 250 billion -- to markets in Central, Eastern, and
Southeastern Europe (CESEE) and the former Soviet
Union (FSU). Austrian banks (and the GOA) argue they
can manage the increased risks, because they have a
solid base of deposits and equity, including GoA
equity injections, sufficient to weather problems in
CESEE/FSU subsidiaries. Despite the global economic
downturn, the CESEE/FSU outlook is generally better
than for Western Europe and a region-wide recession is
not expected. Austrian banks are determined to remain
in eastern markets, which they say are still under-
banked and offer growth potential. An IMF "stress
test" showed considerable resilience of the Austrian
banks against shocks. All Austrian banks active in
CESEE/FSU are "system-relevant" in Austria meaning the
GoA will not let them collapse. Still, banks here do
not rule out 1997/98-style crises, particularly in
Ukraine, Hungary, Bulgaria, Romania, Croatia, and
Kazakhstan. END SUMMARY.

¶2. This cable is based on meetings of Embassy
officers with representatives of several large
Austrian banks with CESEE/FSU operations, information
from the Austrian National Bank/OeNB, new CESEE/FSU
reports of commercial banks, and other sources.

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Position of Austrian Banks in CESEE/FSU
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¶3. According to the OeNB's Financial Stability Report
(released December 15), Austrian banks' Tier 1 capital
ratio in June 2008 was 7.4%, the consolidated capital
adequacy ratio 10.8%. Twelve Austrian banks operate
73 fully consolidated subsidiaries in CESEE/FSU, of
which 37 are in the 12 new EU member states, 23 in
other SEE countries and 13 in FSU. Austrian banks
have a 15.2% share of the entire CESEE/FSU banking
market (21.8% excluding Russia). CESEE/FSU accounts
for 28.5% of Austrian banks' total consolidated
assets, but reaches 40% and more for the five large
Austrian banks active in CESEE/FSU (listed below).
NOTE: Unconsolidated bank assets of banks
headquartered in Austria were EUR 972 billion in June
2008; total consolidated assets (i.e. including
CESEE/FSU subsidiaries) were EUR 1,162 billion, of
which the five largest Austrian banks accounted for

63.3%. END NOTE.

¶4. Five of Austria's six largest banks are major players in the region:
-- Bank Austria/BA
-- Erste Bank/EB
-- Raiffeisen Zentralbank (through its consolidated subsidiary Raiffeisen International/RI which handles the Raiffeisen group's CESEE/FSU business)
-- Volksbanken, and
-- Hypo Alpe Adria/HAA
Examples of Austrian dominance in CESEE/FSU:
-- BA is the largest bank in Bosnia-Herzegovina, Bulgaria and Croatia, number three in Kazakhstan and four in Czech Republic and Ukraine
-- EB is number one in Romania and Slovakia, two in Czech Republic and three in Croatia
-- RI is number one in Albania, two in Kosovo, Serbia and Ukraine, three in Belarus, Bosnia-Herzegovina, Romania and Slovakia, and four in Bulgaria and Croatia.
NOTE: BAWAG, Austria's number five bank, has subsidiaries only in Hungary and Slovenia.

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Subprime Versus CESEE/FSU Risks
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¶5. The subprime crisis had limited impact on Austrian banks. Total write-downs were about EUR 2 billion until mid-2008 and actual losses so far have been only about EUR 200 million, according to the OeNB. Banks were spared immediate fallout due to their strong

CESEE/FSU focus, an "originate and hold" business model, and a focus on retail deposit business along with trade financing. Austrian banks have solid deposit cover of their CESEE/FSU assets (i.e. loans) according to the OeNB. On average, CESEE/FSU receivables are 112% of deposits -- versus 128% in Austria -- but the ratio is over 150% In Hungary, Latvia, Montenegro, Slovenia and Ukraine. The "deposit" deficit is 61% in FSU, 27% in Bulgaria and Romania, 5% in the other CEE countries, and 7% in SEE. Austrian banks are suffering indirect effects of the subprime crisis, i.e., higher refinancing costs, declining revenues from trading and commissions, credit scarcity, and investor risk aversion.

¶6. In the first half of 2008 Austrian banks' unconsolidated -- i.e. domestic -- operating results were down 11.2% compared to the same period in 2007, stemming from lower revenues (down 1.8%) and higher operating expenses (up 4.0%), according to the OeNB's Financial Stability Report. On a consolidated basis, the decline was less strong because of continued strong CESEE/FSU business. So far, Austrian banks have been able to cover write-offs from current revenues and have benefited from their retail banking business focus. An increase in deposits since the beginning of the international financial market crisis strengthens their liquidity position and reflects customer confidence in them. However, strong profits in the region -- for some banks 50-80% of overall profits -- are over for the time being. According to the OeNB, Austrian banks' consolidated profits in 2008 will drop 25% from the 2007 level (which was an exceptionally good year) but still match the levels of 2005/2006.

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Bankers See CESEE/FSU Risks as Manageable
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¶7. Since the Iceland collapse -- unforeseen by rating

agencies, Austrian banks complain -- CESEE/FSU countries with high external deficits have come into critical focus. All Austrian banks active in CESEE/FSU feel that CESEE/FSU risks are limited and that they can continue supporting their subsidiaries, particularly given their strong deposit basis (with the possible exception of Ukraine). However, the region remains under-banked and continues to offer long-term potential to increase financial intermediation. Austrian bankers recognize that the boom days are over and economic growth will slow markedly through 2010 (see para 14 below), but say the region does not now face a recession and retains a strong medium/long-term growth potential based on competitive advantage and a catch-up demand for infrastructure. Austrian bankers like to point to resiliency in emerging Europe ("this is not the first crisis these countries have faced") and express confidence that the EU, and European strategic investors, exert a positive stabilizing influence over most of the region.

¶8. Bankers here recognize the risk inherent in CESEE/FSU markets' dependency on capital inflows to finance economic growth. Foreign banks played a role in that dependency with their strong lending growth. Rising costs of external financing and tighter conditions will now inhibit, rather than fuel, those economies. Austrian bankers point to countries with a greater dependency on foreign funding (and thus higher risk) including Kazakhstan, Latvia, Estonia, and Bulgaria, followed after some distance by Romania, Lithuania and Croatia. Another risk factor is the high share of foreign exchange lending (mostly in Euros) -- which helps Austrian banks manage currency risk but might call into question the credit-worthiness of local borrowers if a local currency depreciates sharply. Countries with exchange-rate pegs are under special pressure: devaluation would lead to payment difficulties because of the private sector's large foreign debts, so any expectation of such a development could trigger capital flight. Austrian banks are concerned but opine that no government in the region has an interest in letting its currency fall sharply, since all (except Russia)

must finance current account deficits and tend to borrow in Euros. (NOTE: Hungary is a partial exception with its forint-denominated floatings, but has other reasons to support the forint, say Austrian financial analysts - END NOTE). Austrian banks are concerned about countries with high public debt including Hungary and much of southeast Europe.

¶9. The biggest concern is Ukraine, particularly if the currency volatility continues, followed by Hungary, Bulgaria and Romania. For most bankers Russia is not a concern: they view it as a special case of a country rich in natural resources. On the Russian bank market, they say the worst seems to be over. Since all system-relevant banks in Russia are owned by the government, state-owned companies or municipalities, the Russian government seems committed to help them -- and the failure of other banks would help promote consolidation. For HAA, its huge exposure in Croatia is a problem. In any case, Austrian bans remain committed to those countries and none i considering pulling out (though they may scale own in one or more countries).

¶10. Bankers expess confidence that the IMF seems prepared to hep any CESEE/FSU country in crisis and the EU willlikely help at least the candidate countries. Te good news includes reforms and instittional deepening; moreover, the public in many

CESEE/FSU markets now has more confidence in banks than in governments and political leadership. However, some Austrian banks says CESEE/FSU governments are not reacting appropriately to the crisis and that the banks have had to send strong messages that they will NOT bail out those markets ("they're on their own" as an interlocutor put it).

¶11. Austrian regulators express strong confidence in their banks' ability to weather any CESEE/FSU storms on the horizon. OeNB Governor Ewald Nowotny has said publicly that Austria will outperform other markets during the current crisis because of their strong presence in CESEE/FSU and has repeatedly predicted that the GOA will not have to cover losses at large Austrian banks. Most bankers -- including at RI and EB -- echo this confident sentiment. UniCredit CEO Allessandro Profumo (head of BA's parent group) has however expressed concern about risk -- which may reflect the fact that BA expanded in CESEE/FSU just before the crisis and may now be confronted with write-downs. For example, in 2007 BA bought 95% of Ukrainian bank Ukrotsbank for EUR 1.5 billion: the other 5% is listed on the stock exchange, where the share price has fallen 80% since the beginning of
¶2008. Also in 2007, BA bought ATF-Bank (the third largest bank in Kazakhstan) for EUR 1.45 billion -- in a market that bankers say is now quite shaky.

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IMF Stress Test: Banks Resilient Against Shocks
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¶13. Even though the situation has deteriorated considerably since the summer, a June 13 IMF stress test of the Austrian banking system (as part of its Financial Sector Assessment Program - FSAP) remains relevant. (NOTE: full text available at www.imf.org/external/pubs/ft/scr/2008/cr08204 .pdf). Key messages of the IMF report are:

-- The Austrian banking system shows considerable resilience against shocks. Banks are well-capitalized, have a moderate attitude toward market risks, follow an "originate and hold" strategy in lending, and have a stable funding source in deposits.

-- The main risk for the Austrian banks stems from the credit risks in CESEE/FSU -- but Austrian banks still have most assets (i.e. loans) in their domestic market.

-- Test results of substantial strain on the banks showed very low or in some cases even negative return on equity, but capital buffers generally remained intact. Severe shocks originating in CESEE and a global downturn causing a prolonged domestic recession

would lead to substantial credit losses of banks and severely affect their return on equity. Only in a few cases would the losses affect base capital, but capital would still remain above 8%.

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New Economic Forecast for CESEE/FSU: No Recession
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¶14. The boom is over, there will be a marked slowdown through 2010, but no recession in the region - these are the key messages of a closely-watched November 27 forecast by the Vienna Institute for International Economic Studies (an independent economic research institute specialized in CESEE/FSU economies). In individual countries -- Hungary, Estonia and Latvia -- a recession is likely but overall growth in the new

EU-10 CEE member states will decline from a 6.3% average in 2007 to 5.0% in 2008 and 2.7% in 2009. A more optimistic scenario puts growth at 3.5% in 2010. The study predicts 2009 growth of 3% in southeast Europe 5.2% in Russia. However, forecasters say their prognosis is especially uncertain at this turning point in the global economy.

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Comment/Assessment
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¶15. While individual CESEE/FSU markets appear quite shaky -- and none is as broad and deep as even Austria -- Austrian banks still say they can manage the risks and potential losses, and no bank is considering a retreat. The economic crisis will lead to markedly lower economic growth in the region, but not/not a region-wide recession and performance will still beat Western Europe, say forecasters here. The size of the GoA banking rescue package gives some reassurance because it takes into account the Austrian banks' CESEE/FSU exposure. Since all five Austrian banks with noteworthy CESEE/FSU subsidiaries are "system-relevant" in Austria -- "too big to fail" -- the GoA will intervene if any starts to teeter. OeNB Governor Nowotny and others remain convinced that relatively small Kommunalkredit bank (reftels) will remain the only bank troubled enough to warrant GoA takeover.

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